MESSAGE FROM THE CHAIR

I look forward to seeing many of you in Washington D.C. for the Annual Meeting at the Marriott Marquis this upcoming September 14-16, 2019!

Among the highlights are our committee lunch on Thursday, September 14, where Lynn Sweet, Chicago Sun Times Washington Bureau Chief, will speak about her career and experience in Washington, then and now. Please also join us for our committee dinner at Brasserie Beck located just blocks from the conference at 1101 K Street NW, Washington, DC. Many thanks to our sponsor Saul Ewing Arnstein & Lehr LLP for sponsoring our dinner.

Our leadership meetings are open, so please drop by and tell us how we can make the committee more valuable and how you would like to get involved!

Erik L. Kantz
Chair, Middle Market and Small Business Committee
Business Law Section

WHAT IS THE MIDDLE MARKET AND SMALL BUSINESS COMMITTEE, AND WHAT DO WE DO?

The mission of the Middle Market and Small Business Committee (“MMSB Committee”) is to serve, educate, and bring together corporate, transactional, and securities lawyers—in an effort to improve the legal profession—who regularly counsel and advise small and mid-sized entities and business ownership groups controlled by matriarchs and patriarchs of family offices, entrepreneurs, private equity groups, venture capital firms, and other groups, and smaller publicly-held companies. To achieve this objective:

- The MMSB Committee provides a forum for its members to share information, to deliver and receive continuing legal education, to address current and practical legal issues affecting smaller and mid-sized businesses, and to learn best practices concerning relevant areas of law, legal ethics, and technology applicable to the delivery of legal services in the 21st Century.
• The MMSB Committee zealously advocates before various regulatory agencies, and has been doing so for decades. Such advocacy concerns current issues and laws that relate to specific problems and needs of small businesses, including smaller public companies. Agencies before which the MMSB Committee and its members regularly advocate include, among others, the Securities and Exchange Commission (“SEC”), the Internal Revenue Service, the Financial Industry Regulatory Authority (“FINRA”), and the National Association of Securities Dealers. For example, our Private Placement Broker Task Force and some of its individual members lobby the SEC, FINRA, and other regulatory agencies to implement a simplified registration system for finders of financing for early-stage companies.

• The MMSB Committee brings scrutiny and discourse to the entire business “life cycle” of our member’s clients with expert panels focused on highly relevant topics such as:
  - entity organization and owner agreements
  - capital formation, financing, and strategic partnering
  - employment and compensation matters
  - intellectual property and trade secrets protection
  - corporate governance
  - securities law compliance
  - international expansion and cross-border transactions
  - business combinations, restructuring, and breakups

COMMITTEE FACTS

Some interesting facts about the MMSB Committee are:

⇒ The MMSB Committee comprises over 1,400 members, both in the United States and abroad.

⇒ The MMSB Committee holds live and in-person meetings 3 times a year in conjunction with the ABA Business Law Section Meetings. The next meeting for 2019 includes the Annual Meeting, being held this year in Washington, D.C. on September 12th through the 14th.

⇒ Meetings of the MMSB Committee typically feature a mini-presentation on a substantive practice area and provide an opportunity to share practical advice relevant for smaller and medium-sized companies as well as the lawyers who counsel them.

⇒ An area in which a great deal of the MMSB Committee’s efforts are directed involves the federal and state securities regulations that affect smaller public companies and capital-raising activities of private companies, including qualifications for exemptions from registration, qualifications for exemptions from registration for private placement brokers, and implementation of scaled disclosure

IN THIS ISSUE

The Business Visions Newsletter continues its ongoing series on start-up activity across the world and also features several other articles, including one on electronic signatures in India. The MMSB Committee is grateful to its members for their contributions. We hope you will read and enjoy these articles and extend a grateful thank you to the authors.

AREAS OF EXPERTISE

Some of the specific areas that are frequently covered by the MMSB Committee in our panel presentations, programs (CLE and otherwise) and workshops include the following:

• Entity organization and owner agreements
• Capital formation, financing, and strategic partnering
• Employment and compensation matters
• Intellectual property protection and transference
• Corporate governance
• Securities law compliance
• International expansion and cross-border transactions
• Business combinations and M&A activities
• Business divorces, breakups, and restructurings
regulations to help smaller and medium-sized businesses be able to raise legally the capital they need to expand their operations and without the need to comply with unnecessary, burdensome, and expensive regulatory requirements.

Membership in the MMSB Committee provides numerous opportunities to participate in CLE panels and workshops, writing opportunities, and opportunities to comment on regulations proposed by the SEC and other regulatory agencies. Participation is strongly encouraged and the MMSB Committee welcomes all levels of experience. Come learn why the Middle Market and Small Business Committee is called The Best Damn Committee in the whole ABA! Please see the Leadership List in Section VII for people you can contact to get more involved.

MEETING INFORMATION

Recap of Spring Meeting in Vancouver, British Columbia in March 2019

Thursday, March 28, 2019
- Start Smart 2.0: Advising Start-ups on Formation and Early-Stage Organizational Issues
- Venture Exchanges: Providing Liquidity to Small Cap Companies?
- Conducting an Effective Internal Investigation – One Chance to Get it Right
- Middle Market and Small Business Luncheon
- Delaware Hodgepodge: A Review of Frequent Questions Delaware Law Practitioners Receive Regarding Private Equity and Venture Capital
- Emerging Companies Subcommittee Meeting
- Middle Market and Small Business Committee Dinner

Friday, March 29, 2019
- Securities Regulation Joint Subcommittee Meeting
- Contractual Governance of Business Entities Joint Task Force Meeting
- Family Owned Businesses Subcommittee
- Short Form M&A Documents Joint Task Force Meeting
- Private Placement Broker Task Force Meeting
- Ten Tips on Board Oversight of M&A Transactions – Governance Handbook Comes to The Rescue!
- Meeting of Subcommittee Chairs, Task Force Chairs, Vice Chairs and Advisory Committee Chairs Meeting
- Middle Market and Small Business Committee Meeting

Overview of ABA Business Law Section Annual Meeting in Sept. 2019

Thursday, September 12, 2019
- Coming to America – European M&A Deal Terms are Increasingly Found in U.S. Deals, 11:30 AM – 1:00 PM
- 10 Things Corporate Lawyers Must Understand about How an LLC is NOT a Corporation, 2:00 PM – 3:30PM

Friday, September 13, 2019
- How to Maximize the Value and Reduce the Cost of Corporate Legal Services, 10:30 AM – 12:30 PM
- Don’t Let Lack of Compliance Derail Your Startup: Practical Approaches to Compliance & Ethics, 2:30 PM – 4:00 PM
ARTICLES FOR SEPTEMBER NEWSLETTER

THE FLOURISHING PHILADELPHIA STARTUP SCENE

By Patrick McKnight, law clerk at Wilson Elser Moskowitz Edelman & Dicker LLP, Philadelphia, Pennsylvania

What are the cities with the most exciting startup cultures? Places like Austin, Silicon Valley, or New York are frequently at the top of the list. But Philadelphia is also making headlines for its vibrant community of entrepreneurs. Many insiders now consider the Philadelphia startup scene one of the best-kept secrets in the local business community.

Why Philadelphia?

Philadelphia is not just the birthplace of the Declaration of Independence and the Constitution. The city and local organizations have also helped give birth to the modern American tech industry. Nearly 200 years after Ben Franklin’s famous kite experiment, the University of Pennsylvania began working on the first electronic general-purpose computer in 1943. Known as ENIAC, the machine was a secret project funded by the Army during the Second World War. ENIAC had a footprint of over 1,800 square feet and contained over 17,000 vacuum tubes, 6,000 manual switches, and 5 million soldered joints.

Today, the greater Philadelphia area is known as the home of some the largest businesses in America, including Comcast, Toll Brothers, Vanguard, QVC, Campbell’s, and Aramark. But small and midsize businesses are increasingly getting their start in the City of Brotherly Love. The city is strategically located near other major markets like New York and New Jersey. And Delaware, the corporate capital of the world, is so close it is actually visible from Philadelphia’s rapidly expanding skyline.

The Philly area is home to a plethora of leading universities, including Penn, Villanova, Temple, Drexel, and Rutgers. Penn’s Wharton School of Business is ranked the top business school in America, and Villanova is ranked number two for online graduate business programs.

Philadelphia is quietly becoming a hotspot for small businesses to get their start. Philadelphia neighborhoods like Northern Liberties and Fishtown are experiencing a renaissance as young people flock to the urban feel and reasonable cost of living. Conferences like Philly Tech Week, Philadelphia Startup Weekend, and the Small Business Expo showcase the technology and innovation proliferating in the Delaware Valley.

The city is home to a growing number of business incubators helping entrepreneurs develop and refine their business plans. An ecosystem of incubators and accelerators has evolved to help entrepreneurs launch dynamic new businesses. One of the best-known local incubators is 1776. In 2017 the Philadelphia-based co-working company “Benjamin’s Desk” merged with the Washington D.C.-founded “1776” to create a new organization operating under the banner of “1776.” 1776 now boasts over 800 startups and 1,000 mentors, and calls itself “the largest entrepreneurial ecosystem for startups in the Northeast Corridor.”

1776 is far from the only incubator serving the region. There are numerous others, including:

- The NextFab Incubator nurtures hardware entrepreneurs.
The local NBA team, the Philadelphia 76ers, launched its Innovation Lab in Camden to connect startups with funding opportunities.

The Project Liberty Digital Incubator gives early-stage companies a base of operations at the headquarters of the region’s largest media network.

UPstart is a “virtual incubator” based out of the University of Pennsylvania supporting entrepreneurship in the life science industry.

The Philadelphia Fashion Incubator works with local fashion designers to assist them in launching their businesses.

Veterans in Residence is a partnership between WeWork and Bunker Labs, and provides entrepreneurial resources to US military veterans.

The Temple Small Business Development Incubator is run by Temple University’s Fox School of Business. It provides access to office space, interns, and consulting and peer mentor programs.

Rutgers Camden School of Business offers a Small Business Development Center.

Rutgers is also home to the Camden Technology Campus, a mixed-use incubator based just across the Ben Franklin Bridge. The Camden tech cluster recently made the front page of INC Magazine earlier this year.

The Baiada Institute Incubation Space is open to Drexel students seeking the resources and mentorship to start their first business.

Her Corner has a Philadelphia presence assisting female entrepreneurs with financials and marketing.

Philly iHub helps immigrant-entrepreneurs turn their ideas into action plans.

Entrepreneurs in Philadelphia increasingly utilize business accelerators to launch and scale their businesses. One the best-known Philadelphia accelerators is DreamIt, an early investor in mobile-based ticket platform SeatGeek. In 2009 DreamIt was among SeatGeek’s first seed investors. Today, SeatGeek is one of the most successful ticket platforms in the country. Other important local accelerators includes the Philly Startup Leaders Accelerator, Backstage Capital Accelerator, LIFT Labs Accelerator, Global Startup Accelerator, EO Accelerator, the Ben Franklin Fintech Accelerator, VIP-Xcelerate, Elevate!, Innovation Accelerator Program, Idea Accelerator, RAPID Hardware Accelerator, Village Capital Pathways, and the Digital Health Accelerator. StartUpPHL is a public/private partnership providing venture funding to Philadelphia-based startups.

Philadelphia startups are developing an admirable track record. Invite Media was founded in 2007 as a display advertising and exchange bidding company. Just three years later, the Philly start-up was acquired by Google for $81 million. Penji, a rapidly growing graphic design startup in Philly, has added hundreds of paid subscribers in only two years and is another example of success.

Robert Moore, an entrepreneur, investor and writer based in Philadelphia, has started three successful businesses in Philadelphia, including Stitch, a data warehousing service for developers launched in 2016. Moore argues that the Philly tech community has an abundance of talented individuals available at a more affordable cost than any other area. That value is critical for new ventures operating on a limited budget. For example, Moore claims launching his company in Philly instead of Silicon Valley saved him $1.1 million.

A Legacy of Community That Continues Today

Philadelphia has a growing number of local organizations designed to develop the next generation of local teach leaders and entrepreneurs. Coded by Kids is a Philadelphia non-profit preparing students for tech-focused entrepreneurship. Girl Develop It is a nonprofit providing women affordable, hands-on software development instruction. On the other side of the Delaware River, Hopeworks helps young people in Camden learn to code. Their goal is to break the cycle of poverty
and violence through technology and entrepreneurship. All these community groups share a common mission of educating and mentoring young people into leaders and entrepreneurs.

A growing number of networking and membership organizations also support the Philadelphia start-up ecosystem. StartupPHL provides tech and entrepreneurial training, and is a collaboration between the Philadelphia Department of Commerce and PIDC, a non-profit organization founded by the City of Philadelphia and the Greater Philadelphia Chamber of Commerce in 1958, whose mission is to spur investment, support business growth, and foster developments that create jobs, revitalize neighborhoods, and drive growth to every corner of Philadelphia. Philly Startup Leaders connects leaders in the tech startup community through meet-ups and workshops. The Entrepreneurs’ Forum of Greater Philadelphia offers education and monthly networking opportunities. The Philadelphia Alliance of Women Entrepreneurs supports female founders with events and resources. The Women’s Business Development Center is another valuable resource for female entrepreneurs. The Wharton’s School of Business’ Enterprise Center supports minority entrepreneurs with information about funding opportunities, business education, and community development. The Sustainable Business Network of Greater Philadelphia is dedicated to building opportunities in the green economy.

Conclusion

Philadelphia has a unique combination of rich history and a promising future. The city’s ongoing renaissance is owed in part to an exciting tech boom creating new opportunities for small businesses. It’s not just Austin and Silicon Valley anymore. The City of Brotherly Love deserves to be added to the list of American startup cities.

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USE OF ELECTRONIC SIGNATURES IN INDIA

By Disha Mohanty, Partner, and Gayathri Subramanian, Associate, Archer & Angel, in New Delhi, India

With increased focus on digitization, India's business landscape has undergone a paradigm shift. The Government of India (“Central Government”) has also declared an initiative called “Digital India,” encouraging business processes to become more efficient by applying digital solutions across verticals. As companies increase the use of electronic documents, it is essential to understand the legal implications of using electronic signatures.

Here are some frequently asked questions on the current position of electronic signatures in India:

1. **How are Electronic Signatures defined under Indian Law?**

   Electronic signatures and electronic authentication techniques have been given legal recognition by the Central Government under the Information Technology Act, 2000 (“IT Act”). In general parlance, the term “electronic signatures” signifies all means of electronically signing documents, but under the IT Act the term "Electronic signature" means "authentication of any electronic record by a subscriber by means of an electronic technique specified in the Second Schedule and includes digital signature”.

2. **What are the pre-requisites for an electronic signature/electronic authentication technique to be considered valid by the Central Government?**

   As per the IT Act, an electronic signature/authentication technique shall be considered valid, only if:

   a. the data corresponding to the electronic signature is unique to the person using it;
   b. the electronic signature data is under the exclusive control of the person using it;
   c. any alteration to the electronic signature after its affixation is detectable;
   d. any alteration to the contents of the document made after its authentication by electronic signature is detectable; and
   e. it fulfils such other conditions prescribed by the Central Government.¹

¹ Electronic Signature or Electronic Authentication Technique and Procedure Rules, 2016
3. **What are the types of electronic signatures currently approved by the Central Government?**

At present, the Central Government recognizes only two types of electronic signatures to be valid: A) Digital Signatures using asymmetric crypto system and hash function; and B) eSign Online Electronic Signature Service (which uses Aadhaar eKnow Your Customer services or One Time Password based authentication).

4. **What is the legal validity of documents signed using electronic signatures in India?**

In India documents are considered legally valid if they are executed using either of the forms of electronic signatures recognized by the Central Government; i.e., A) Digital Signatures and B) eSign Online Electronic Signature Service.

However, affixation of electronic signatures through a mechanism that has not been specifically recognized by the Government in India is not necessarily invalid. In such a scenario, if the validity of the contract is disputed, the burden of proof of to establish that the signatures actually belong to the parties executing the contract shifts to the party claiming the contract to be valid.

5. **What are the types of documents which can be executed via electronic signatures?**

Any legal document that is not filed with, or required by, any governmental authority may be executed using electronic signatures, including commercial agreements between private parties, documents used by Human Resource departments such as employment contracts, and commercial contracts for sale of goods and provision of services. For the reason stated above, if you are relying on electronic signatures, it is advisable that you only use of the type of electronic signatures recognized by the Central Government to mitigate any risks.

6. **Are there any specific documents which cannot be executed using electronic signatures?**

Yes, as per the IT Act, certain documents cannot be authenticated using electronic signatures and include:

i. A Negotiable instrument (such as a promissory note, bill of exchange or check);
ii. A Power of attorney;
iii. A trust deed;
iv. A Will or any other testamentary disposition; or
v. Any document for transfer or conferring title of immovable property or real estate.

7. **Are contracts that are executed by alternative forms of electronic signatures, other than those specified by the Government, enforceable?**

The IT Act provides that electronic contracts shall not be unenforceable merely because they are in electronic form. However, use of any other means of signing (apart from the forms of electronic signatures notified by the Central Government) would be open to dispute and proving their authenticity and reliability would be the onus of the party asserting the authenticity of the document.

For persons opting to use electronic signatures for executing crucial legal contracts in India, seeking prior legal advice is recommended to ascertain the validity of the mode of electronic signatures and the enforceability of such documents, which may vary according to the nature of the envisaged transaction.

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2 Please refer to question 6.

3 Aadhaar is an individual identification number that is issued by the Unique Identification Authority of India on behalf of the Indian Government to persons resident in India on the basis of their general and biometric information such as fingerprints and iris scans.
Managers of Delaware limited liability companies can be compelled to appear in Delaware courts if they are either formally named as managers under the LLC’s operating agreement (“formal managers”) or if they “participate[ ] materially in the management of the limited liability company” (“acting managers”). 6 Del. C. § 18-109(a). LLCs can be either “member-managed,” where the vote of holders of a majority of the membership interests governs, or “manager-managed,” where the LLC agreement provides for a formal manager.

In Metro Storage International LLC v. Harron, 2019 Del. Ch. LEXIS 272 (Del. Ch. July 19, 2019), the defendant, Harron, served as the acting manager of two Delaware LLCs. Although both LLCs were manager-managed, Harron was not the formal manager of either one. Based on the fact that Harron did manage the day-to-day operations of the two LLCs, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery found that Harron participated materially in their management and thus satisfied the plain language of the statute.

Harron argued, however, that to be an acting manager under the statute, a person must occupy a “control or decision-making role” and that any time an LLC agreement vests authority in a formal manager, another person cannot have a control or decision-making role and the LLC therefore cannot also have an acting manager. He also argued that a person who participates in management of an LLC as an agent for another cannot be an acting manager.

The “Control Overlay” Argument

The Court of Chancery referred to the first argument as the “control overlay” argument based on cases in which courts “added a layer to the material-participation test by holding that persons are not amenable to service as acting managers unless they occupy a ‘control or decision-making role.’” In the first such case, Florida R & D Fund Investors, LLC v. Florida BOCA/Deerfield R & D Investors, LLC, 2013 Del. Ch. LEXIS 216 (Del. Ch. Aug. 30, 2013), the Court of Chancery “mentioned the phrase ‘control or decision-making role’ once, in passing, without citing authority to support the formulation, and without providing any reason for departing from the statutory material-participation test.” The Court in Metro Storage found that “Later decisions have followed its language without testing the foundation’s footings.”

In the second case, Wakley Ltd. v. Ensotran, LLC, 2014 U.S. Dist. LEXIS 34918 (D. Del. Mar. 18, 2014), the United States District Court for the District of Delaware, following Florida R & D, “made the control overlay more onerous by interpreting a ‘control or decision-making role’ as requiring that the person named as a defendant be ‘effectively running [the entity’s] entire business.’” The District Court “elevated the control overlay from a passing phrase to an operative test, while further elevating the necessary level of involvement to require ‘effectively running [the LLC’s] entire business.’”

In Metro Storage, the Court of Chancery found that a more recent opinion of the Delaware Supreme Court, Hazout v. Tsang Mun Ting, 134 A.3d 274 (Del. 2016), “requires abandoning” the control overlay. Hazout addressed the analogous consent-to-service statute for directors and officers of Delaware corporations, 10 Del. C. § 3114. That statute provides for personal jurisdiction in two kinds of cases: (i) “all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such officer is a necessary or proper party,” and (ii) “any action or proceeding against such officer for violation of a duty in such capacity.” But in Hana Ranch, Inc. v. Lent, 424 A.2d 28 (Del. Ch. 1980), the Court of Chancery held that Section 3114 applied only to “claims asserting that the defendant had breached duties owed to the corporation or its stockholders,” abrogating the “necessary or proper party” portion of the statute. Hana Ranch was followed for 36 years, until the Delaware Supreme Court rejected it in Hazout, finding “it is our obligation to give effect to the plain language of statutes to the extent we can do so without offending any supervening constitutional limits.” The Delaware Supreme Court thus restored the Delaware courts’ personal jurisdiction over corporate officers and directors in keeping with the statute.
In *Metro Storage*, the Court of Chancery found that the same reasoning should apply to the consent statute for managers of LLCs; the control overlay violates the plain language of 6 Del. C. § 18-109(a), which provides for jurisdiction over persons who participate materially in the management of a Delaware LLC, and is not limited by its terms to persons in a control or decision-making role.

**The “Formal Manager Designation” Argument**

Next, Harron argued “that a defendant cannot serve as an acting manager if the operative LLC agreement contains a formal manager designation.” In *Fisk Ventures, LLC v. Segal*, 2008 Del. Ch. LEXIS 158 (Del. Ch. May 7, 2008), the defendant, Fisk Johnson, was a major investor who had the right to appoint two members to the LLC’s “Board of Member Representatives.” The plaintiff, Segal, argued that Johnson was an acting manager because he “(i) controlled his board appointees and (ii) participated in the management of [the LLC] through broad veto rights.” The Court of Chancery in *Fisk Ventures* rejected the first part of the argument, finding that Johnson did not materially participate in management.

The Court in *Fisk Ventures* also rejected the second part of the argument. The company’s LLC agreement provided that the members of the LLC “shall conduct, direct and exercise full control over all activities of the company through their representatives of the board.” The Court concluded that “the designation of the board as the formal manager precluded Johnson from qualifying as an acting manager.” The Court in *Metro Storage* found that, because the material participation test was not met, “[t]he reference to the formal manager designation in the [ ] LLC agreement did not add anything to the analysis.”

In support of the formal manager designation argument, Harron cited three cases, *Wakley Ltd. v. Ensotran, LLC*, 2014 U.S. Dist. LEXIS 34918 (D. Del. Mar. 18, 2014) (discussed above), *In re Dissolution of Arctic Ease*, 2016 Del. Ch. LEXIS 185 (Del. Ch. Dec. 9, 2016), and *CelestialRX Investments, LLC v. Krivulka*, 2019 Del. Ch. LEXIS 102 (Del. Ch. Mar. 27, 2019). The Court found that those cases were “not persuasive precedents.” In *Wakley*, the District Court found that although a defendant had “broad authority,” “her power was ‘subject to the decisions and instructions of the board.” The Court concluded that the defendant “is not a ‘manager’ under § 18-109(a)(ii) because she did not participate materially in the management of [the LLC].” The Court in *Metro Storage* found that “This brief reference does not appear to have played a meaningful role in the court’s analysis.”

In *Arctic Ease*, the LLC’s managing member argued that the Court of Chancery had personal jurisdiction over an investor because the investor participated materially in management. The Court found that because the LLC had a managing member who was empowered by the LLC agreement to manage the company, the defendant “could not have served in the type of ‘control or decision-making role’ necessary to satisfy the control overlay.”

Similarly, in *CelestialRX*, the Court of Chancery found that a former board member “could not have participated materially in management because he no longer occupied a control or decision-making role.” The Court in *Metro Storage* found that in all three cases the factual allegations did not support jurisdiction under the plain-language test, and that they all “reached outcomes for which the formal manager designation was unnecessary.” The Court also found that the formal manager designation argument derived from the control overlay argument that it had already rejected and that it originated from a misreading of case law.

The Court also found that the structure of the Delaware LLC Act required rejection of the formal manager designation argument. Section 18-402 of the LLC Act provides that by default LLCs are member-managed and that for an LLC to be manager-managed its LLC agreement must so provide. If only formal managers could participate materially in management, a manager-managed LLC could not have acting managers. However, Section 18-109(a) of the LLC Act “contemplates that any LLC, including a manager-managed LLC, can have acting managers.” The Court concluded “Because LLCs have flexible governance structures and often operate with a relatively high degree of informality, the broader formulation enables Delaware courts to exercise personal jurisdiction over key individuals who take action on behalf of the entity.”
The “Agency Shield” Argument

Harron’s third and final argument was that “if a person participates materially in the management of an LLC while acting as an agent, then the person’s actions as agent cannot support a finding of material participation because the agent is acting on behalf of his principal.” In Wakley, the Court stated that the plaintiff failed to convince the Court that the defendants “were not acting at the direction of, and as representatives for”, the investor who appointed them. The Court in Metro Storage rejected this “agency shield” argument, finding that it was a version of the “fiduciary shield” doctrine, “which holds that when an officer or other agent for an entity engages in acts within a jurisdiction in an official capacity, the agent is not subject to jurisdiction based on official acts, but only for acts committed in a personal capacity.”

The Court found that “Scholars have thoroughly critiqued the fiduciary shield and argued for its rejection,” that it conflicts with the Delaware long-arm statute, 10 Del. C. § 3104(c)(1), which authorizes service of process on a person who engages in forum-directed activity “in person or through an agent,” and the common-law agency theory of jurisdiction, which allows the exercise of jurisdiction over a non-resident principal by attributing the jurisdictional contacts of the agent to the principal.

The Court thus rejected the agency shield argument, and concluded that Section 18-109(a)(ii) can be used to serve a person “even if the person acted as an agent of the LLC or its formal manager.”

By rejecting Harron’s arguments and hewing to the plain language of the LLC Act, the Court of Chancery restored the jurisdiction of Delaware courts over acting managers of Delaware LLCs in keeping with the statute. Acting managers of Delaware LLCs and their counsel should be aware that any person who participates materially in the management of a Delaware LLC can be haled into a Delaware court in any case “involving or relating to the business of the limited liability company or a violation by the manager . . . of a duty to the limited liability company or any member of the limited liability company....” 6 Del. C. § 18-109(a).

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DOES A LAWYER DRAFTING AN EMPLOYMENT AGREEMENT WITH AN APPARENTLY UNENFORCEABLE COVENANT VIOLATE THE RULES OF PROFESSIONAL CONDUCT?

By Gerald V. Niesar, Partner, and Carolina Juvin, Associate, Niesar & Vestal LLP, San Francisco, California

The University of San Diego School of Law Center for Public Interest Law proposes that an attorney who participates as drafter or reviewer of an employment agreement should face disciplinary sanctions if the agreement contains a post-employment covenant not to compete or non-solicitation agreement.

Introduction: California’s Statutory Prohibition of Covenants Not to Compete.

California Business and Professions Code Section 16600 mandates that “every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.” 4 The best case to read concerning this statute is Edwards v. Arthur Anderson LLP, 44 Cal. 4th 937 (2008). After the collapse of Arthur Anderson (“AA”), Edwards was offered employment by a spin off entity called Wealth and Tax Advisory Service (“WTAS”). WTAS required that, as a condition of employment, Edwards (and all other former AA employees) would have to sign a Termination of Non-Competition Agreement (“TONC”) drafted by AA, pursuant to which Edwards would waive significant potential claims against AA in exchange for the termination by AA of the covenant not to compete that was in his AA employment agreement. The specific covenant in the AA employment agreement prohibited Edwards from soliciting any clients of AA with whom he had worked (18 months), any other person who was a client of AA while he was employed by

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4 Other sections of the B&P Code allow covenants not to compete in connection with the sale of all of one’s interest in a business: Section 16601 (sale of all assets, goodwill or interests in a business), Section 16602 (partnerships) and Section 16602.5 (LLC Member Interests). These exceptions are to make possible the seller’s ability to obtain fair payment for the goodwill of the applicable business; without an enforecable covenant not to compete, no buyer would likely pay anything for goodwill.
AA (12 months) and any AA professional AA employed while Edwards was an employee (18 months). Edwards refused to sign the TONC and WTAS refused to hire him. Edwards sued AA and WTAS claiming the covenants were unenforceable because of Section 16600. Prior to Edwards, the Ninth Circuit had held in a series of cases that where the offending provision is limited and leaves a large or substantial portion of the market available to the employee, Section 16600 does not apply (the “narrow restraint” exception). In Edwards, the California Supreme Court overruled the Ninth Circuit holding that any restriction on the former employee’s right to compete, no matter how narrow or minimal, violates Section 16600 and is, therefore, void and unenforceable.

It is fair to say that most California attorneys, during the decade following the Edwards opinion in 2008, did not consider that the provision in the AA employment agreement prohibiting solicitation of other AA employees was void and unenforceable under Section 16600. Then, in November 2018, the California Court of Appeal, in AMN Healthcare, Inc. v. Aya Healthcare Services, Inc., 28 Cal. App. 5th 923 (2018), held that a “non-solicitation of employees” provision is also unenforceable under Section 16600. Subsequently, two Federal District Courts have followed AMN Healthcare, so that it now appears that, barring a California Supreme Court decision overturning AMN Healthcare, an employment agreement under California law cannot contain an enforceable covenant that would bar the employee from soliciting away his or her former employer’s other employees.

The Center for Public Interest Law Letter.

On June 5, 2019, the Center for Public Interest Law at University of San Diego School of Law (the “CPIL”) sent a letter (the “Request Letter”) to the State Bar of California, Committee on Professional Responsibility and Conduct (“COPRAC”) requesting a formal ethics opinion on the subject of attorneys’ involvement in “drafting, reviewing (without comment), approving and/or causing to be signed an employment contract ... that contains contractual provisions that the lawyer knows or should know are unambiguously illegal and unenforceable”. Specifically, the Request Letter points to Rule 8.4(c) of the Rules of Professional Conduct (the “Rules”), which prohibits “conduct involving dishonesty, fraud, deceit, or reckless or intentional misrepresentation”, and Rule 1.2.1 which prohibits “counsel[ing] a client to engage, or assist[ing] a client in conduct that the lawyer knows is criminal, fraudulent, or a violation of any law, rule or ruling of a tribunal.”

In fairness to CPIL, it should be noted that the Request Letter also focuses on employment agreement provisions that would require the employee to arbitrate any dispute under the agreement before an out-of-state arbitrator selected by the employer. In 2016, California amended its Labor Code by adding Section 925, which prohibits an employer from including in an employment agreement a provision requiring the employee, who primarily resides and works in California, to arbitrate an employment dispute in a foreign jurisdiction.

Concerns with the CPIL Request Letter.

The specific perceived abuses that the Request Letter addresses relate to clauses that are often included in employment agreements that: (a) impose a post-employment non-compete agreement on the employee; and/or (b) impose a post-employment non-solicitation (of the employer’s other employees) agreement on the employee; and/or (c) require the employee to agree that, as to any dispute arising under the employment agreement, the employer has the unilateral right to select an arbitrator, including an out-of-state arbitrator, to rule upon the dispute. In connection with item (c) above, the concern noted in the Request Letter is that the unilateral right to select an arbitrator would violate Labor Code Section 925(a)(1), which prohibits an employer from requiring, as a condition of employment, that the employee agree to adjudicate outside of California a claim “arising in California”. With respect to items (a) and (b) above, the Request Letter appears to focus on Business and Professions Code Section 16600 and cases interpreting that Section.

Making the drafting or reviewing of employment agreements containing any of such clauses a per se violation of the Rules could put an attorney in an untenable position with respect to her or his duties to the employer client. The best example is

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5 Generally, we refer to a prohibition against soliciting clients as a “covenant not to compete”; and a prohibition against soliciting employees as a “non-solicitation agreement or covenant”.

with respect to a post-employment covenant not to compete or solicit employees. There are at least two situations in which such agreements may be enforceable. First, if the employer can demonstrate that the employee, by taking employment with a competitor, has afforded to the new employer knowledge of the employer’s critical trade secrets or confidential proprietary information, the covenant may be enforced. See Thompson v. Impaxx, Inc. 113 Cal. App. 4th (2003). Second, even if the covenant may not be enforceable in California, the ex-employee may be employed in a state where the covenant is enforceable. Because there may be situations as just described where the covenant may be enforceable, such covenants in an employment agreement between a California employer and California employee are not “unambiguously illegal or unenforceable” as the Request Letter implies.

With respect to the provision requiring out-of-state arbitration, there is a serious ambiguity in Labor Code Section 925(a)(2). That statute provides that an employer may not make it a condition of employment that the employee agree to a provision that would “deprive the employee of the substantive protection of California law with respect to a controversy arising in California.” If the employee quits to take employment with the employer’s arch competitor in another state, has the controversy arisen in California? Quitting the employment in California does not create the controversy; taking employment in the other state would create the controversy. Thus, can it be said that a clause in the employment agreement that would require the employee to arbitrate or adjudicate in a foreign jurisdiction selected by the employer, is “unambiguously illegal or unenforceable”? Section 925 unambiguously prohibits a provision that would require the employee to adjudicate in another state “a claim arising in California”. But that does not mean the California Legislature has prohibited, or has the right to prohibit, enforcement of the offending agreement if the claim does not arise in California. Again, focusing on behavior of the former employee committed outside of California, the requirement to adjudicate in another jurisdiction may well be enforceable.

In most cases, the concerns with employment agreements of the type that are discussed in the Request Letter would seem to be resolved by existing law. We can accept that use of covenants not to compete may intimidate some employees as noted in the Request Letter. However, if that is a serious concern, and we agree it might be, it would seem more appropriate for the Legislature to deal with the abuse issue by giving employees an effective remedy such as the right to recover a statutory penalty, plus attorney’s fees if the ex-employer attempts to enforce the unenforceable provision in California. The attempt to make the attorney responsible for the breach of the law by the employer does not appear justifiable. It could create a conflict of interest for the attorney: he or she can protect himself or herself from possible State Bar disciplinary action, or he or she can faithfully discharge his or her duty with respect to legitimate concerns of the employer-client.

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PRO-RATA RIGHTS EXPLAINED

By Matthew J. Moisan, Counsel, The Tech Group, Lowenstein Sandler LLP

In the realm of venture capital-backed companies, a term often heard and frequently misunderstood, at least by founders and even “unsophisticated” investors, is Pro-Rata Rights. Simply put, Pro-Rata investment rights provide early investors the right to participate in later fundraising rounds in order to preserve their ownership percentage as the company raises more capital. While the definition is easy enough to understand, the implications of offering it, or not, to early investors are regularly overlooked. Early stage founders often agree to granting this provision to early investors – when the need for initial investment is dire – but may experience unforeseen pains down the road when future, larger rounds of investing occur.

Why do Investors want Pro-Rata Rights?

When making risky, highly speculative investments, such as those in early stage startup businesses, investors – both institutional and individuals – have an expectation that there is a possibility for a large return. In other words, the return matches the risk structure. Angel and venture investors see a high percentage of their investments go to companies that do not make it. When they do invest in a “winner”, a company that is going to create significant returns, investors want to maximize their value. Pro-Rata Rights enable the investor to maintain the largest equity stake possible and not be diluted
by future rounds, if they choose to exercise. Pro-Rata Rights offer the investors the option to continue investing in subsequent fundraising rounds in order to maintain their original ownership percentage as the company increases in value. Without Pro-Rata Rights, the early investors risk being diluted by each subsequent round of financing. While investors can still earn a return without making a Pro-Rata investment, it may be a much smaller amount than they would have earned had they continued investing and maintaining the percentage of ownership they had when first investing in the company’s earlier, lower priced rounds.

**Why not offer Pro-Rata Rights to all of your Investors?**

At initial glance, a founder might, and often does, think that it is no big deal to grant Pro-Rata Rights to any early investor who asks. After all, they took the big risk on you early on, shouldn’t they be entitled to continue to share in the success? While in theory that seems logical, in practice this can create numerous issues for founders at later stages. The first major issue that occurs is when a large, later stage investor would like to come in and take a considerable portion of the subsequent fundraising round. This new investor is willing to do so at a high valuation, and this can be a major value add. It is likely that their fund has certain principles; possibly a minimum investment amount or an ownership percentage threshold they need to achieve. Unfortunately, when early stage investors have Pro-Rata Rights, this new investor may not be able to achieve their investment goals because the early investors have a right to a large portion of the round. In this scenario, founders will need to have early investors waive their Pro-Rata Rights – a difficult discussion to have as your company is growing in value. Further, the early investors are under no obligation to do so, and their unwillingness could potentially prevent a major fundraising round from occurring.

Alternatively, an issue can arise when early investors holding Pro-Rata Rights opt not to exercise them in a subsequent round. This can happen for many reasons – they do not have the means, it is not part of their strategy, etc. – however, this can sometimes be seen as a red flag to the lead investors of the new round of financing. After all, the early stage investors have had an inside look at the company for longer than the new investors, have an opportunity to continue investing, yet have chosen not to. Again, they may have chosen not to for valid reasons having nothing to do with the trajectory of the company, but this can appear as a lack of confidence in the company.

Lastly, when companies pick and choose who to offer Pro-Rata Rights to at early stages, without set criteria, they may find themselves with disgruntled early stage investors later on, who were not offered the benefit of these rights that other investors received.

While these are not all of the issues that may arise in the granting of Pro-Rata Rights, this article highlights some of the main reasons why granting such rights should not be taken lightly. In the event you need to grant them to early stage investors, at the very least founders should do so with clear criteria on who will receive them; possibly those who meet a minimum investment amount. The situational needs of companies vary and sometimes granting Pro-Rata Rights is potentially beneficial, or unavoidable; and before entering into such arrangements, business parties should discuss in-depth the implications involved with legal counsel.

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**DOING BUSINESS IN ONTARIO**

_By Michael Henry, Managing Partner, Houser Henry & Syron LLP, Ontario, Canada_

- Looking to establish or expand a business in Ontario?
- This article provides an overview of the business and legal issues to consider before doing so.

How do you establish a business in Ontario? Purchase a manufacturing plant or lease office space? Hire employees? Decide on a type of business entity? Acquire a local business? This article provides business owners, both from within Canada and outside of the country, with an overview of important business and legal issues to consider to successfully establish and operate a business in Ontario.
There are many facets to starting a business in a new location. Our intention with this guide is to highlight the important information business owners should know as they begin the process. This article examines the main areas critical to operating a business in the province: selecting the type of business entity, tax considerations, employment, and real estate. We hope it serves as a valuable primer to proceeding with your business plans.

I. About Ontario

Ontario is Canada’s most populous province with approximately 13 million people. It is home to Canada’s federal capital, Ottawa. Ontario’s provincial capital is Toronto, Canada’s most populous city and its financial center.

Economically, Canada has outperformed most other countries in recent years, and Ontario has traditionally been its engine. Companies are often attracted by Ontario’s well-educated and skilled workforce, its environment of innovation, and its central location within North America. Several studies have found that Ontario is a great place to do business. KPMG’s 2016 Competitive Alternatives study of international business costs confirmed Canadian business costs are among the lowest in the G7, and Forbes.com recently named Ontario a top destination for foreign direct investment in North America. Other advantages Ontario offers to foreign investors or businesses seeking to expand include a sound banking sector, large and active capital markets, a simple and inexpensive process of incorporation, few import restrictions, and easy access to other North American markets. There are also government incentive programs that involve financial assistance and/or tax incentives, such as competitive corporate income tax rates, tax-free intercorporate dividends, and reduced withholding tax rates for treaty countries.

II. Establishing a Business in Canada: Business Presence and Form

A. Expansion Methods

There are numerous methods available to foreign businesses looking to expand into Canada. Before committing to any one method, it is important to discuss the ramifications with both legal and tax counsel. As opportunities and obligations evolve, the foreign entity can be adapted from one form to another to meet changing business needs. The methods of expansion include:

1. Licensing

Licensing is the simplest method of expanding into Canada. A company can avoid establishing a physical presence in a geographical area in which it wants to conduct business by way of a license agreement. A license is a business arrangement where one party (the licensor) gives specific rights in some or all of its property, usually intellectual property (IP), such as its trademark, patent, or industrial design, to another party (the licensee). The licensee is then allowed to use the IP or other property in exchange for a fee or royalty. License agreements protect the business interests and intentions of each of the parties. Some of the more important factors that should be considered in the negotiation of a license agreement include:

1) the term or length of the agreement as well as any rights or options to renew the agreement and rights to terminate the agreement;
2) the territorial or geographical boundaries that are covered by the agreement;
3) the specific IP or other property being licensed;
4) how payment will be made, including the amounts to be paid as well as payment dates and bonuses and/or penalties;
5) whether the license is to be exclusive or nonexclusive, the permitted uses, and any limitations or exclusions with respect to how the IP or other property is used;
6) any support or training provided by the licensor;
7) whether the licensee is required to provide a warranty on the licensed goods and any limitations on the licensor’s responsibility;
8) how the licensed goods are to be marketed and sold as well as how much money is to be spent in doing so;
9) the requirement for nondisclosure of confidential information as well as noncompete conditions;
10) the responsible party for defending potential IP infringement claims;

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7 The information in this publication is current as of March 15, 2019. The content should not be taken as legal advice. It is not exhaustive and is subject to change.

8 For information on tax credits, see https://www.fin.gov.on.ca/en/credit/business.html (for provincial tax credits), and www.canadabusiness.ca/eng/page/2738/ (for federal tax credits).
11) a plan for what happens when the agreement is terminated; and
12) how and where disputes will be resolved.

2. Distributor and Agency Agreements

If a foreign company wants to sell goods in Canada, but wants to avoid establishing a physical presence, then a distributor or agency arrangement may work. In an agency relationship, an agent acts on behalf of the principal (the foreign company). Agents may or may not have the ability to legally bind the principal for which they are acting.

Agency differs from a distribution relationship. A distributor is an independent party that typically buys the goods and then offers them for resale. Distributors normally cannot bind their suppliers. If engaging a distributor, the foreign company should enter into a written agreement with the distributor that sets forth the parties’ respective rights and obligations, including how the agreement can be terminated and what notice is required.

3. Foreign Branch

A foreign company that wishes to establish a physical presence in Canada but avoid creating a separate legal entity may want to consider opening one or more foreign branch offices. The foreign branch will likely need a license in Ontario in order to carry on business in the province (an extra-provincial license) and may need to register its business name (discussed later). This form of expansion can have tax advantages in that Canadian losses can be claimed by the parent company in its home jurisdiction. However, it also means the foreign company will be subject to Canadian income tax on its Canadian branch income and all the liabilities of the Canadian branch.

4. Canadian Subsidiary

Another option is to incorporate a Canadian subsidiary. Unlike a foreign branch, liabilities incurred would be limited within the subsidiary and not imposed on the parent foreign company (except in the case of ULCs, which are discussed below).

Companies can be incorporated in Canada at either the provincial or federal level. For most purposes, federal and provincial business corporations are able to conduct business anywhere within Canada and abroad. When choosing to incorporate provincially or federally, it is important to be aware of the differing rights and obligations that exist. These include requirements involving the location of the head office, Canadian residency requirements for directors, and shareholders rights. Discuss your particular situation with legal counsel to ensure you choose the appropriate jurisdiction for incorporation.

An unlimited liability corporation (ULC) is a special type of corporation that currently exists in only three of Canada’s provinces: Alberta, British Columbia, and Nova Scotia (not Ontario). Unlike limited liability corporations, the shareholders of a ULC can be liable for any liabilities of the company; however, ULCs also allow some flow-through tax benefits to shareholders.

5. Partnerships

A partnership involves two or more persons carrying on a business in common with a view to profit. Partnerships are either general partnerships or limited partnerships.

In a general partnership, each partner is entitled to participate in the ownership and management of the organization. Each partner also assumes unlimited liability for the debts and obligations of the partnership. This relationship can arise without a formal written agreement; however, it should be set out in a written partnership agreement. A limited partnership requires at least one general partner. The general partner is subject to unlimited liability for the debts of the partnership and manages the partnership’s business. General partners can be, and usually are, corporations with no other purpose or assets. Limited partners, however, are only liable to the extent of their capital contribution and are not permitted to take part in the management of the business (or they risk losing their limited liability).

All forms of partnership can offer some flow-through tax benefits to partners that are not available to shareholders of corporations.

6. Buying a Canadian Business

Finally, another option is to buy an existing Canadian business. Buyers interested in acquiring a business in Ontario must complete due diligence on the potential acquisition, plan the financing required to complete the purchase, and determine how the business will be integrated with the buyer’s other business(es) or assets.
B. Business Registrations

1. Extra-Provincial License (EXPL)

A corporation that was incorporated in a jurisdiction outside of Canada must obtain an EXPL to carry on business in Ontario.\(^9\) “Carrying on business” is defined broadly and covers most business/commercial activities. It includes, but is not limited to, having an agent, representative, warehouse, office, and/or an interest in real property (such as a land mortgage) in Ontario.

Canadian, non-Ontario companies seeking to carry on business in Ontario do not need an EXPL, but must file information with the Ministry of Government Services.

LLCs (familiar to many U.S. businesses) cannot be created under Ontario law. They are a hybrid between a corporation (in that they offer limited liability to stakeholders) and a partnership (for some tax benefits). Foreign LLCs are able to carry on business in Ontario, but the requirements for them are different than for foreign corporations. Although an LLC is usually regarded as an “unincorporated organization” for corporate purposes in Ontario, it may still be treated like a corporation for tax purposes.

2. Business Number (BN)

All businesses must apply for a BN with the Canada Revenue Agency (CRA) if the business needs one or more of these CRA program accounts: (1) goods and services tax/harmonized sales tax (GST/HST); (2) payroll; (3) import/export; or (4) corporation income tax (discussed later). The BN acts as the business’s single account number for dealing with the federal government.

3. Trademarks

Registration under the federal Trademarks Act is optional; however, registration will help a business protect its trade name(s) and/or business name(s).

4. Business Name

Under the Ontario Business Names Act (BNA), if a business uses a business name that differs from the individual's name (in the case of a sole proprietorship), the names of the partners (in the case of a partnership), or from its corporate name (if a corporation), it must register that business name in Ontario.

Before deciding on a business name, ensure that the name is not already used by, or could be confused with the name of, another entity. The BNA does not grant any rights to the registered name in Ontario; however, a business may be able to protect a trade name by registering a trademark under the federal Trademarks Act. The BNA also does not prohibit the registration of identical names, but if a business decides to use a name that is the same as or confusingly similar to that of an existing business, then it can result in a legal action.

5. Ontario Employer Health Tax (EHT)

Ontario's employers are required to pay tax on remuneration paid to its employees, known as the EHT. Some employers are exempt from EHT on the first $490,000 of their annual Ontario payroll. Currently, the EHT tax rates range from 0.98 percent on total remuneration less than $200,000 to 1.95 percent for total remuneration over $400,000. This tax is intended to fund the Ontario Health Insurance Plan (OHIP).

6. Ontario Workplace Safety and Insurance Board (WSIB)

Most employers in Ontario must report the earnings of employees working in Ontario and pay WSIB insurance premiums on those earnings. The WSIB provides insurance for injuries and illnesses incurred in workplaces and supports early and safe return to work for injured workers. WSIB coverage also protects employers from lawsuits related to work injuries and from the direct cost of these injuries. Workers injured on the job cannot sue their employer, but they can be paid by the WSIB to replace lost earnings and health care costs resulting from work-related injuries and illnesses.

If a business employs people and does not register with the WSIB, it will face financial and legal penalties. This includes fines up to $100,000 and/or imprisonment. Workers are covered even if the employer is not registered; in this situation, the employer must also pay the full costs of any workplace injury or illness claim. Some employers are exempt from WSIB premiums; their employees are not entitled to WSIB benefits.

\(^9\) Extra-Provincial Corporations Act § 4(2).
III. Establishing a Business in Canada: Tax

A. Tax Liability: Income Tax on Canadian Activity

Residents and nonresidents with income from a taxable source in Canada are required to file a Canadian tax return and pay income tax. A corporation will generally be considered a resident of Canada if: (1) it was incorporated and carried on business within Canada; or (2) the “central management and control” of the corporation occurs in Canada (even if the business was incorporated in and/or has major operations in a foreign country). Countries may enter into a bilateral tax treaty with the goal of reducing or eliminating double taxation and promoting international trade. Canada has entered into bilateral tax treaties with 90 different countries.

1. Income Tax

Canada has a progressive tax system. Sole proprietors and partners in a partnership are taxed at the individual level. The rates of tax increase as the income of the individual increases. In 2019, the federal individual income tax rates ranged from 15 percent for the first $44,630 of income to 33 percent for income over $210,371. The 2019 Ontario individual income tax rates were 5.05 percent on the first $43,906 of taxable income to 13.16 percent on taxable income over $220,000.

Canadian corporations pay a flat rate of income tax. The current federal corporate tax rate is 15 percent, and the Ontario corporate tax rate is 11.5 percent. The combined rate for incorporated businesses operating in Ontario is therefore currently at 26.5 percent.

2. Capital Gains/Losses

A capital gain is the profit from the sale of an asset like real estate or securities, such as stocks and bonds. This profit is taxable upon the sale or disposition of the asset. In Canada, the buying and selling of property is given favorable tax treatment in that only half of the capital gain is taxable at the taxpayer’s marginal income tax rate. Where a taxpayer sells an asset at a price lower than the original purchase price, the resulting capital loss may be set off against taxable capital gains for the current year. Where capital losses exceed capital gains in the year, a net capital loss is generated, which may be carried backwards to any of the three previous years, or forward indefinitely. The application of such losses reduces the amount of capital gains tax payable.

Foreign investors are obliged to obtain a clearance certificate (under section 116 of the Income Tax Act) from the Canadian taxing authorities when disposing of taxable Canadian property. Unless the foreign vendor has obtained a clearance certificate, purchasers have a duty to withhold and remit a portion of the purchase price to the Canadian taxing authority. If the property is not treaty-protected, the nonresident vendor must generally forward an amount equal to 25 percent of the capital gain plus applicable tax to obtain the clearance certificate. If the property is treaty-protected, the clearance certificate will generally be issued without the prepayment of tax.

B. Other Types of Taxes

1. Land Taxes

If you buy land or an interest in land in Ontario, you must pay provincial land transfer tax ranging from 0.5 percent to 2 percent depending on the type of land and its purchase price. Certain municipalities, such as Toronto, also levy a municipal land transfer tax in addition to the provincial land transfer tax.

Municipalities charge annual property taxes on the assessed value of real estate. Assessments are made based on the current or average current value of similar properties. The applicable property tax rates are set by the municipality annually and vary depending on the class of property.

2. Payroll and Other Employment Taxes

Businesses that have employees have a number of payroll-related expenditures. Federally, employers are obliged to make contributions for income tax, Employment Insurance (EI), and the Canada Pension Plan (CPP). Provincially, all employers in Ontario must pay the Employer Health Tax and, if applicable, make contributions to the WSIB to provide for workers who are unable to work due to an accident arising out of a work-related injury or disease.

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10 For more information on determining the residency of a corporation, see Canada Revenue Agency, Residency of a Corporation.
11 For more information on countries with which Canada has tax treaties, see Canada Department of Finance, Tax Treaties: In Force.
12 Canada Revenue Agency, Corporation Tax Rates.
13 Canada Revenue Agency, Information Circular IC72-17R6.
3. Withholding Tax

Nonresidents may be subject to Canadian withholding taxes on certain types of passive income. Income paid out to nonresidents in the form of interest, rent, royalties, dividends, and other specified amounts is subject to a default 25-percent withholding tax.\(^\text{14}\) This amount may be varied by tax treaty. For example, under the tax convention between Canada and the United States, U.S. residents pay a reduced tax on dividends issued from a Canadian business and are not required to pay any tax on interest generated from Canada unless it is tied to a permanent establishment.\(^\text{15}\)

Nonresidents who are paid a “fee, commission or other amount in respect of services rendered in Canada” (i.e., “actively” earned income) are subject to a default 15-percent withholding tax.\(^\text{16}\) Tax treaties do not exempt nonresidents from having to pay this 15-percent withholding tax; however, Canadian tax authorities may nevertheless grant a waiver of withholding taxes upon application.

4. Branch Tax

Nonresident foreign corporations that carry on business in Canada through a branch rather than through a Canadian subsidiary are subject to a 25-percent branch tax.\(^\text{17}\) This tax is in addition to income tax payable on all Canadian-source income. The branch tax serves as a stand-in for the withholding tax that would otherwise have been levied on dividends issued to the nonresident parent had the business instead been carried on through an incorporated Canadian subsidiary.\(^\text{18}\) The branch tax may be reduced by reinvesting branch profits in Canadian business assets or according to the terms of a tax treaty.\(^\text{19}\)

C. CRA Program Accounts

Opening CRA program accounts is the first step for a business to meet its tax obligations. There are four major CRA program accounts:

1. GST/HST

The federal government and the Province of Ontario impose a sales tax on the consumption of goods and services in Canada. This tax is known as the GST/HST and is at 13 percent. Although the burden of paying this tax is borne by the consumer, businesses are obligated to collect and remit this tax to the Canadian taxing authorities.

Businesses that provide taxable goods and services must charge their clients GST/HST. Businesses can also claim input tax credits to recover the GST/HST they pay on goods and services consumed, used, or supplied in their commercial activities.\(^\text{20}\)

A business must register for a GST/HST account if it (resident or nonresident) provides taxable goods or services in Canada and its revenues exceed $30,000 a year.

2. Payroll

Most employers must register for a payroll account to deduct and remit the income tax of its employees. An employer must open the payroll account before the first remittance date, which falls on the 15th day of the month following the month one becomes an employer.\(^\text{21}\)


\(^{15}\) https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4061/nr4-non-resident-tax-withholding-remitting-reporting-2016.html

\(^{16}\) Canada Revenue Agency, Businesses-International and non-resident taxes, Rendering services in Canada, Tax treatment of non-residents who perform services in Canada.

\(^{17}\) Canada, Natural Resources Canada, Canadian International Income Tax Rules, Taxation of Foreign Investment in Canada, Branches.

\(^{18}\) Id.

\(^{19}\) Id.

\(^{20}\) BN CRA at 10.

\(^{21}\) BN CRA at 20.
3. **Import/Export**

If a business will be importing commercial shipments from a foreign country into Canada, or exporting commercial goods to other countries, it must register for an import/export account. The CRA will use the import/export account number to process customs documents.\(^{22}\)

4. **Corporation Income Tax**

All corporations operating in Canada must file a corporation income tax return within six months of the end of each tax year (its fiscal year). When a business incorporates in Ontario or federally, the business will automatically be registered for a BN and a corporate income tax program account. Nonresident corporations will also be registered with a corporation income tax account when they apply for a BN with the CRA.\(^{23}\)

**IV. Establishing a Business in Canada: Employment**

The information in this section relates to nonunionized employees and their employers in Ontario. The rights and duties of unionized employees and their employers are governed by the agreement between the parties and Ontario’s labor laws.\(^{24}\) The relationship between employees who work for “federal undertakings or businesses” (which include banks, telecommunication companies, and transportation companies) and their employers is governed by federal laws. The fact that a company is federally incorporated does not necessarily mean that its employees will be governed by federal employment or regulatory laws.\(^{25}\)

This section also does not apply to independent contractors, which differ from employees. Many people try to classify themselves as independent contractors so they can deduct expenses for tax purposes when in fact they are employees. Employers may also try to classify employees as independent contractors so that they are not obligated to provide termination pay or severance. These obligations are discussed below in further detail.

### A. **The Employment Standards Act (ESA) Minimum Standards**

The ESA and its regulations provide standards for employee wages, hours of work, overtime entitlement, and vacation entitlement, among other things. Some employees may be exempt from particular standards, and employers should discuss this issue with Ontario legal counsel.

The ESA also provides employees with certain protected leave-of-absence entitlements. An employee cannot be penalized by an employer for taking a protected leave of absence. These include pregnancy, parental, personal emergency, family medical, organ donor, declared emergencies (for emergency personnel), and reservist leaves (for members of the Canadian military). If employers have any questions as to whether an employee is entitled to a leave of absence, they should ask Ontario legal counsel.

Employers should have a written employment agreement with their employees and make signing of the agreement a condition of any job offer.

### B. **Occupational Health and Safety and Workers’ Compensation**

Employers must comply with Ontario’s Occupational Health and Safety Act (OHSA). OHSA seeks to keep workplaces healthy and safe for Ontario’s workers. Ontario’s Ministry of Labour will investigate when there is an accident involving workers or if a complaint is made. As previously mentioned, most Ontario employers are required to obtain WSIB coverage for its employees. Employers who violate the OHSA can face severe penalties.

Depending on the size and nature of an employer’s workforce, the employer may be required to have a “joint health and safety committee” or “health and safety representatives” that include employees. Employers must cooperate with the committee and/or representatives on health and safety matters.

OHSA also imposes regulations regarding toxic substances and other dangerous work conditions. If a worker reasonably feels unsafe at work, he or she can stop working or refuse to work.

Importantly, OHSA also addresses workplace violence and harassment. Employers must have a written violence and harassment policy in place that clearly outlines unacceptable behavior, how a complaint can be made and is investigated,

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\(^{22}\) BN CRA at 18.


\(^{24}\) For more information about Ontario’s labor laws, see [Ontario Ministry of Labour](https://www.ontario.ca).\(^{25}\)

\(^{25}\) For more information about federal employment and labor laws, see federal [Labour Program](https://www.canada.ca).
and how violence or harassment will be dealt with by the employer. If an employer fails to appropriately deal with violence or harassment in the workplace, the employer could be liable.

C. Human Rights Law and Pay Equity

Employers must also comply with the Ontario Human Rights Code, which stipulates that employers cannot discriminate against employees (or prospective employees) on any of the following grounds: race, ancestry, place of origin, skin color, ethnic origin, citizenship, creed (religion), sex (includes gender identity and pregnancy), sexual orientation, age, marital status, family status, disability (includes perceived disability), or record of offenses. If an employer discriminates against an employee (or prospective employee) on any of these grounds, that person could bring a complaint against the employer at the Ontario Human Rights Tribunal, and the employer could be ordered to pay compensation. In addition to the Human Rights Code, Ontario has pay equity legislation to address gender-based wage discrimination.

“Disability” is defined broadly under the Human Rights Code. A disability is not always obvious and must be handled with sensitivity. Employers are strongly encouraged to consult with Ontario legal counsel when dealing with an employee who has, or claims to have, a disability.

Employers in Ontario must accommodate employees with disability. Accommodation involves arranging the employee’s workplace or duties to enable the employee to do his or her work, if this can be done without undue hardship to the employer.

D. Termination of Employment

The concept of “at will” employment does not exist in Canada. Employees are either employed for a specific period of time or for an indefinite period. If individuals are employed on an indefinite basis, they must generally be given notice (or pay in lieu of notice) if their employment is terminated without cause. Whether an employee is entitled to receive notice of termination and/or other compensation depends on how and why their employment is being terminated.

1. Termination without Cause

Most terminations are “without cause,” meaning that the termination is not because of any specific charge or problem in the employee’s performance or behavior. Compensation for this type of termination is established by the written employment agreement between the employee and the employer, or if there is no such agreement, then by the common law and the ESA.

Under the ESA, an employee whose employment is terminated without cause is entitled to receive a minimum prescribed amount of notice of termination or, alternatively, pay in lieu of notice if the employer wishes to terminate the employee’s employment immediately. The maximum ESA termination pay is eight weeks. This is generally a lump-sum payment equivalent to what the employee would have been paid had he or she worked for the employer during the notice period. The longer the employee has served, the longer the notice period.

Where a person’s employment is terminated without cause and the employee has served for five or more years, the employer may also be required to pay severance in addition to termination pay if one of the following applies:

- the employer has an annual payroll of $2.5 million dollars (CAD) or more;
- the termination is in connection with the permanent discontinuance of all or part of the employer’s business at an establishment, and 50 or more employees are terminated within a six-month period.

The ESA provides a formula for calculating severance pay. The maximum ESA severance pay is 26 weeks.

In addition to notice of termination (and severance pay, if applicable), the ESA also requires that employees be paid accrued and unpaid vacation pay. Vacation pay will vary depending on how much annual vacation the employee receives.

The minimum standards in the ESA are absolute minimums and cannot be lowered by employment agreements. Ontario courts typically award longer notice periods than those provided under the ESA. Under Ontario common law, an employer must give an employee “reasonable notice” of termination (or pay in lieu of reasonable notice), unless the employee is terminated for just cause. The amount of notice required depends on various factors, which usually include:

- the character or nature of the employment (e.g., was the employee a management or non-management employee?);

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26 OHSA SS 32.0.1(1)(a), (c).
• the length of the employee’s service;
• the employee’s age;
• the availability of similar employment, having regard for the experience, training, qualifications, and
responsibilities of the employee;
• the circumstances surrounding the hiring of the employee; and
• any written employment agreement between the employee and employer.

Employers should consult with Ontario legal counsel to ascertain what reasonable notice would entail in each particular circumstance.

2. Termination for Cause

In a termination for cause, an employee must be guilty of significant misconduct, and there is no entitlement to notice or compensation. Employers are advised to seek legal counsel before terminating someone’s employment when they believe there is cause for termination.

3. Constructive Dismissal

An employer cannot unilaterally change a material term of a person’s employment unless the employee agrees to the change, or the change is specifically permitted by a written employment agreement. The law treats the employer’s implementation of a material change as a “constructive dismissal” of the employee. Constructive dismissal usually occurs when an employer significantly reduces an employee’s salary or changes the employee’s work location, hours, authority, position, or benefits (e.g., extended health insurance) in a negative way. It may also occur if an employer harasses an employee or condones such conduct by other employees. Constructively dismissed employees are entitled to the same notice (or pay in lieu of notice) and other compensation as if their employment were terminated without cause.

4. Fixed-Term Employees

If an employee is hired for a fixed period of time, but let go before the end of that term, the employer must pay the employee for the balance of the term unless an employment agreement provides otherwise, or unless the person’s employment is terminated as a result of a breach of the agreement. An employee who agrees to a fixed employment period is not entitled to notice (or pay in lieu of notice) or other compensation that extends beyond that term. However, if an employee continues to be employed after the fixed term has expired without a new or extended agreement, he or she can become an employee for an indefinite term of employment and be entitled to notice (or pay in lieu of notice) if his or her employment is later terminated without cause.

E. Mandatory Retirement

There is no mandatory retirement age in Ontario. An employer cannot force an employee to retire or quit at a particular age. Employers cannot discriminate against employees on the basis of age. If they do so, they could face allegations that they have violated the Human Rights Code.

F. Noncompetition and Nonsolicitation Agreements

Nonsolicitation agreements and noncompetition agreements contain restrictive covenants that restrict what a person may do. A restrictive covenant must meet certain criteria in order to be enforceable. It must be reasonable between the employer and employee, and reasonable with reference to the public interest in a free and competitive marketplace.

1. Nonsolicitation Agreements

Nonsolicitation agreements should only serve to prevent a former employee from attempting to “hire away” other employees and to “take business” from his or her former employer by approaching existing (or recent) customers of the employer with offers of similar goods or services. A nonsolicitation agreement should have time and/or geographic limits (e.g., valid for a two-year period after employee’s employment ends, or valid within the province of Ontario). If a nonsolicitation agreement is too broad, then it may be deemed to be a noncompetition agreement.

2. Noncompetition Agreements

Noncompetition agreements can severely limit an employee’s ability to find similar work after his or her employment ends. Courts in Ontario are typically reluctant to enforce noncompetition agreements because they often lessen competition generally. A noncompetition agreement will generally be upheld only if there are exceptional circumstances. For example, if there is a sale of a business, the key person(s) involved in that business can be prevented from starting a
competitive business for a certain period of time after closing. Further, a noncompetition agreement may be upheld against a manager or other senior person within an organization.

Courts have made it clear that they will only enforce restrictive covenants when they are reasonable in their entirety. Courts will not sever overreaching terms or interpret ambiguous terms.

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(SC = Subcommittee Chair; SCC = Subcommittee Co-Chair; SVC = Subcommittee Vice-Chair; TFC = Task Force Chair;
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If anyone has any ideas concerning future editions of the MMSB Committee’s newsletter, or would like to get more involved with the Newsletter Subcommittee, please contact Andrew W. Monthey at awmonthey@gmail.com or Mark D. Hobson at mdh@hfk.law.

LISTSERV PROTOCOLS

a) Listserv. The MMSB Committee encourages all of its members (especially those who have recently joined) to become active participants in all committee activities, including participating in discussions on our Listserv. It is a great way to learn about current legal issues affecting your practice. The Listserv provided by the MMSB Committee (“MMSB Listserv”) is a great medium with which to solicit the advice of your peers, benefit from their experience and participate in an ongoing conversation about relevant topics. To be able to send a message through the MMSB Listserv, however, you must first be a member of the MMSB Committee and separately register and establish an additional password on the ABA’s Listserv platform in order to access this functionality. All Listserv participants are also required to comply with the Rules & Etiquette Guidelines described below.

b) Listserv Archive. Members of the MMSB Committee who are fully signed up for the Listserv and logged in to the Listserv platform can access the extensive MMSB Listserv archive at the following link: Listserv Archive

c) Rules & Etiquette Guidelines for Use of the MMSB Listserv.

The MMSB Committee has established Rules & Etiquette Guidelines that will govern all participants’ use of the MMSB Listserv. If a participant fails to adhere to these Rules & Etiquette Guidelines, the MMSB Committee may suspend or terminate that person’s future participation on the MMSB Listserv.

The Rules & Etiquette Guidelines for use of the MMSB Listserv can be found on the ABA’s website.
REQUESTS FOR SUBMISSIONS/SPONSORS

Dear Middle Market and Small Business Committee Members:

Our Committee is always actively seeking sponsors and volunteers, and we need your continued help. Please continue reading below to learn how you can contribute to our Committee’s success.

Having sponsors will provide a financial contribution to help fund Committee dinners. But perhaps more importantly, sponsors can provide a strategic relationship with our committee and provide substantive content and market intelligence during Committee meetings as well as participate in our CLE programs. Efforts to secure additional sponsors are being led by Michel Gélinas (mgelinas@stikeman.com). If you have any leads or suggestions, please let Michel know.

If you are interested in preparing a short, substantive article on a topic that is relevant for our Committee, please contact Andy Monthey at awmonthey@gmail.com or Mark D. Hobson at mdh@hfk.law.

All articles for the newsletter should be minimal in length (up to 2,000 words). In addition to being circulated to our approximately 1,400 members, your article may also be eligible for publishing in the Business Law Section’s Business Law Today, a monthly publication circulated to approximately 37,000 members.

Thanks to everyone for your support!

Erik L. Kantz
Chair, Middle Market and Small Business Committee
Business Law Section
ABA Committee Associate Program

The ABA’s Committee Associate Program (“CAP”) is designed to build relationships between law students and members of the ABA Business Law Section (the “Section”), by giving students the opportunity to gain experience through substantive and administrative projects with committees of the Section.

The MMSB Committee is continually seeking associates to help write (i) articles and (ii) summaries of the various activities of the MMSB Committee’s subcommittees and task forces for inclusion in our newsletter. Articles and summaries will be based on live programs from the MMSB Committee’s Fall, Spring and Annual Meetings as well as other MMSB Committee meetings, webinars, and lunches that feature one or more speakers. CAP Associate(s) will work with the program presenters and speakers to write certain articles, and also have the opportunity to work with program presenters and speakers to help draft and eventually possibly submit article(s) for publication in the ABA’s Business Law Today. Published articles will be drafted primarily by the program presenter or speaker. Attending meetings is required and since travel is not reimbursable, the MMSB Committee is seeking primarily law students who are local to each of the next Fall, Spring and Annual Meetings.

The duration of the position is for at least the applicable meeting and completion of article(s) arising from the same meeting that the CAP Associate(s) attended.

Law students may apply by visiting the CAP website for an application.